

January 1998

YEAR 2000 COMPUTING CRISIS

Actions Needed to Address Credit Union Systems' Year 2000 Problem



DISTRIBUTION STATEMENT A

Approved for public release;
Distribution Unlimited

19980113 112

DTIC QUALITY INSPECTED 3

Accounting and Information
Management Division

B-278831

January 7, 1998

The Honorable Norman E. D'Amours
Chairman
National Credit Union Administration

Dear Mr. D'Amours:

On October 22, 1997, we submitted testimony to the Senate Subcommittee on Financial Services and Technology, Committee on Banking, Housing, and Urban Affairs on the National Credit Union Administration's (NCUA) efforts to ensure that credit union computer systems are ready for the upcoming Year 2000 date change.¹ In our testimony, we reported that while NCUA had made some progress in addressing Year 2000 compliance issues, more needed to be done to ensure that credit unions adequately mitigate Year 2000 risks. This report (1) officially transmits recommendations to assist NCUA in addressing the Year 2000 problem, (2) responds to your comments on our testimony, and (3) recognizes actions NCUA has taken in response to our recommendations. Our testimony, which includes our objective, scope, and methodology, and findings, conclusions, and recommendations, is reprinted in appendix I. Your response to our testimony is reprinted in appendix II.

Recommendations

As stated in our October 22, 1997, testimony, we recommend that NCUA

- accelerate its efforts to complete the assessment of the state of the industry, collect the necessary information to determine the exact phase of each credit union and vendor in addressing the Year 2000 problem, and require credit unions to report the precise status (phase) of their efforts on at least a quarterly basis, including progress in addressing system interfaces;
- document its contingency plans;
- require credit unions to implement the necessary management controls to ensure that these financial institutions have adequately mitigated the risks associated with the Year 2000 problem, including (1) requiring credit union auditors to include Year 2000 issues within the scope of their management and internal control work and report serious problems and corrective actions to NCUA immediately and (2) providing auditors with the

¹Year 2000 Computing Crisis: National Credit Union Administration's Efforts to Ensure Credit Union Systems Are Year 2000 Compliant (GAO/T-AIMD-98-26, October 22, 1997).

DTIC QUALITY INSPECTED 5

-
- procedures developed by NCUA for its examiners to use in assessing Year 2000 compliance and any other guidance that would be instructive;
 - require credit unions to establish processes whereby credit union management would be responsible for certifying Year 2000 readiness including credit union compliance testing by a qualified independent third party; and
 - determine (before the end of 1997) the level of technical capability needed to allow for a thorough review of credit unions' Year 2000 efforts and hire or contract for this capability.

Agency Comments and Our Evaluation

In your October 30, 1997, letter response to our testimony, you stated that the testimony contained useful recommendations and described actions that NCUA is taking or has taken to implement our recommendations. These actions included (1) implementing quarterly credit union reporting of Year 2000 status that includes having credit union officials certify their level of progress, (2) developing written contingency plans to augment current processes for administrative actions, and (3) using a contractor to perform technical reviews of 10 electronic data processing vendors. You also stated that, depending on the outcome of these reviews, NCUA would consider contracting for additional reviews of other electronic data processing vendors, credit unions that develop and maintain their own systems, and large credit unions. In addition, in a November 12, 1997, letter to the Congress, you said NCUA would be issuing a letter to credit unions in December 1997 to describe the potential problems and develop information on steps credit unions should take to manage the interface issue. Finally, on December 1, 1997, you issued a letter, including examination procedures, to the credit union supervisory committees notifying them of the need for internal and external auditors to review Year 2000 plans and testing processes.

However, you also raised a concern with one of our recommendations. Specifically, you stated that, as part of its quarterly reporting process, NCUA plans to require credit union managers to certify their progress in addressing the Year 2000 problem. You also stated that independent third party certification of progress would be unnecessarily burdensome to a majority of credit unions. By requiring credit unions to certify their progress, NCUA is effectively alerting credit unions that they are responsible and accountable for addressing the Year 2000 problem and, as such, is a step in the right direction. However, without independent verification that credit union systems are Year 2000 compliant, NCUA will be relying solely on management assertions and therefore will not have

assurance that credit unions are progressing as reported. To effectively mitigate this risk, NCUA needs to ensure that the information being reported to it is accurate and reliable. Consequently, we reiterate our recommendation that the certification process include credit union compliance testing by a qualified independent third party and allow sufficient time for NCUA to review the results and take appropriate action, if needed, before the year 2000.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight not later than 60 days after the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

We are sending copies of this letter to the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs; the House Committee on Banking and Financial Services; the Senate and House Committees on Appropriations; the Senate and House Committees on the Budget; the Senate Committee on Governmental Affairs; and the House Committee on Government Reform and Oversight. We are also sending copies to the Director of the Office of Management and Budget, the Chairman of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the Director of the Office of Thrift Supervision. Copies will also be made available to others upon request.

Please contact me on (202) 512-6240 if you or your staff have any questions on this report. Major contributors to this report are listed in appendix III.

Sincerely yours,

A handwritten signature in black ink, appearing to read "J. L. Brock, Jr."

Jack L. Brock, Jr.
Director, Information Management Issues

Contents

Letter	1
Appendix I GAO's October 22, 1997 Testimony	8
Appendix II Comments From the National Credit Union Administration	18
Appendix III Major Contributors to This Report	27

Abbreviations

NCUA National Credit Union Administration

GAO's October 22, 1997 Testimony

GAO

United States General Accounting Office

Testimony

For the Subcommittee on Financial Services and
Technology, Committee on Banking, Housing, and Urban
Affairs, U.S. Senate

For Release
at 10 a.m.
Wednesday,
October 22, 1997

YEAR 2000 COMPUTING CRISIS

National Credit Union Administration's Efforts to Ensure Credit Union Systems Are Year 2000 Compliant

Statement for the Record by
Jack L. Brock, Jr.
Director, Information Resources Management/
General Government Issues
Accounting and Information Management Division



GAO/T-AIMD-98-20

Appendix I
GAO's October 22, 1997 Testimony

Mr. Chairman and Members of the Subcommittee:

We are pleased to be asked to provide our views on the progress being made by the National Credit Union Administration (NCUA) in ensuring that automated information systems belonging to the thousands of credit unions that NCUA oversees are ready for the upcoming century date change. If the Year 2000 problem is not addressed in time, credit union computer systems—which affect billions of dollars of assets and transactions—will be unable to readily process transactions or produce accurate information. According to NCUA, without properly functioning systems, credit unions like other financial institutions face the potential of failure.

This testimony is the first in a series of reports you requested on the status of efforts by federal financial regulatory agencies to ensure that the organizations they oversee are ready to handle the Year 2000 computer conversion challenge. To prepare for this testimony, we performed a quick overview of NCUA's efforts to date to ensure that credit unions have adequately mitigated the risks associated with the Year 2000 date change and compared these activities to our *Year 2000 Assessment Guide*.¹ In performing the overview, we interviewed NCUA officials responsible for examining and overseeing the safety and soundness of credit union management practices and procedures. We reviewed examination policies, procedures, and manuals—including specific examination procedures for assessing Year 2000 compliance. We also reviewed NCUA correspondence to credit unions and third-party contractors (that provide automated systems services to many credit unions) regarding the Year 2000 problem. Finally, we interviewed officials from the Credit Union National Association, the National Association of State Credit Union Supervisors, and the CUNA Mutual Group (which provides liability insurance for the credit union industry). We provided a draft of this testimony to NCUA for review and comment. NCUA officials stated that they would provide written comments at a later date. We performed our work at NCUA headquarters in Alexandria, Virginia, between October 7 and 17, 1997, in accordance with generally accepted government auditing standards.

¹*Year 2000 Computing Crisis: An Assessment Guide* (GAO/AIMD-97-14, September 1997). Published as a exposure draft in February 1997 and finalized in September 1997, the guide was issued to help federal agencies prepare for the Year 2000 conversion. It addresses common issues affecting most federal agencies and presents a structured approach and a checklist to aid in planning, managing and evaluating Year 2000 programs. The guide describes five phases—supported by program and project management activities—with each phase representing a major Year 2000 program activity or segment. While the guide focuses on federal agencies, it is general enough that nonfederal organizations can also use it to assess their automated systems.

As requested, my testimony today will highlight the Year 2000 problem's potential impact on credit unions and their systems. I will then discuss NCUA's Year 2000 strategy and highlight our observations with its efforts to ensure that credit unions are appropriately addressing the problem.

In summary, we found that the Year 2000 problem poses a serious dilemma for credit unions because they like other financial institutions rely heavily on information systems. We also found that NCUA recognizes the severity of the problem, has developed a plan, and has initiated action. For example, NCUA issued several letters to the credit unions informing them of the risks associated with Year 2000 problem. In addition, working in conjunction with other federal financial regulators, NCUA developed procedures for examiners to use in reviewing credit union Year 2000 efforts. However, we are concerned with NCUA's approach because (1) current agency efforts to determine industrywide compliance are behind the generally accepted schedule for achieving Year 2000 compliance, and, consequently, NCUA does not yet have a complete picture of where credit unions stand individually or as an industry, (2) the agency lacks a formal, documented contingency plan in case credit unions do not become compliant in time or have other problems, (3) credit union internal auditors may not be thoroughly addressing Year 2000 issues as part of their work, and (4) NCUA does not have enough technical capability to conduct Year 2000 and other examinations in complex systems areas.

The Year 2000 Problem Poses a Serious Dilemma for Credit Unions

Credit unions are nonprofit financial cooperatives organized to provide their members with low-cost financial services. According to NCUA, as of 1996, federally insured credit union assets totaled \$326 billion. About one in four Americans belongs to a credit union, and credit unions accounted for about 2 percent of the total financial services in the United States.

NCUA supervises and insures more than 7,200 federally chartered credit unions and insures member deposits in an additional 4,200 state-chartered credit unions through the National Credit Union Share Insurance Fund. As part of its goal of maintaining the safety and soundness of the credit unions, NCUA is responsible for ensuring credit unions are addressing the Year 2000 problem.

The Year 2000 problem is rooted in the way dates are recorded and computed in automated information systems. For the past several decades, systems have typically used two digits to represent the year, such as "97" representing 1997, in order to conserve on electronic data storage

Appendix I
GAO's October 22, 1997 Testimony

and reduce operating costs. With this two-digit format, however, the year 2000 is indistinguishable from 1900, or 2001 from 1901. As a result of this ambiguity, system or application programs that use dates to perform calculations, comparisons, or sorting may generate incorrect results.

According to NCUA, most credit unions rely on computers to provide for processing and updating of records and a variety of other functions. As such, the Year 2000 problem poses a serious dilemma for the industry. For example, the problem could lead to numerous problems when calculations requiring the use of dates are performed, such as calculating interest, calculating truth-in-lending or truth-in-savings disclosures, and determining amortization schedules. Moreover, automated teller machines may also assume that all bank cards are expired due to this problem. In addition, errors caused by Year 2000 miscalculations may expose institutions and data centers to financial liability and risk of damage to customer confidence. Other systems important to the day-to-day business of credit unions may be affected as well. For example, telephone systems could shut down as can vaults, security and alarm systems, elevators, and fax machines.

In addressing the Year 2000 problem, credit unions must also consider the computer systems that interface with, or connect to, their own systems. These systems may belong to payment system partners, such as wire transfer systems, automated clearing houses, check clearing providers, credit card merchant and issuing systems, automated teller machine networks, electronic data interchange systems, and electronic benefits transfer systems. Because these systems are also vulnerable to the Year 2000 problem, they can introduce and/or propagate errors into credit unions systems. Accordingly, credit unions must develop comprehensive solutions to this problem and prevent unintentional consequences from affecting their systems and the systems of others.

To address these Year 2000 challenges, GAO issued its Year 2000 Assessment Guide² to help federal agencies plan, manage, and evaluate their efforts. The Office of Management and Budget (OMB), which is responsible for developing the Year 2000 strategy for federal agencies, also issued similar guidance. Both require a structured approach to planning and managing five delineated phases of an effective Year 2000 program. The phases include (1) raising awareness of the problem, (2) assessing the complexity and impact the problem can have on systems, (3) renovating or correcting systems, (4) validating, or testing, corrections, and

²GAO/AIMD-96 L14 September 1997.

(5) implementing corrected systems. GAO has also identified other dimensions to solving the Year 2000 problem, such as identifying interfaces with outside organizations and their systems and establishing agreements with these organizations specifying how data will be exchanged in the year 2000 and beyond. In addition, GAO and CMB have established a timeline for completing each of the five phases and believe agencies should have completed assessment phase activities last summer and should be well into renovation with the goal of completing this phase by mid to late 1998. Our work at other federal agencies indicates that because the cost of systems failures can be very high, contingency plans must be prepared so that core business functions will continue to be performed even if systems have not been made Year 2000 compliant.

**NCUA Has Developed
a Strategy and Has
Initiated Action to
Address the Year 2000
Problem**

NCUA has developed a three-pronged approach for ensuring that credit unions are aggressively addressing the Year 2000 problem, which encompasses (1) incorporating the Year 2000 issue into its examination and supervision program, (2) disseminating information about the problem to credit unions, and (3) assessing Year 2000 compliance on the part of credit union data processing vendors.

The first aspect of NCUA's strategy, the examination and supervision program, involves assessing credit union Year 2000 efforts through regular annual examinations at the 7,200 federally chartered credit unions and 30 to 40 percent of the 4,200 federally insured, state chartered credit unions for which NCUA conducts an insurance review. These examinations seek to identify credit unions that are in danger of not renovating their systems on time and to reach "formal agreements" that specify corrective measures. In conducting these reviews, examiners are to follow NCUA guidelines, which provide step-by-step procedures for identifying problem areas. Once a formal agreement is reached, the examiner is expected to monitor the credit union's implementation of the agreed-upon corrective measures. Also as part of its examination effort, NCUA has contracted a consulting firm to train selected examiners in Year 2000 efforts. Through this training, NCUA expects to have one in-house Year 2000 specialist available as a resource for every eight examiners. In addition, NCUA's board recently authorized the hiring of an electronic data processing (EDP) auditor to provide more in-depth technical assistance and education on Year 2000 problems.

Another part of NCUA's examination and supervision strategy includes working with state regulators to ensure that federally insured, state

chartered credit unions are also Year 2000 compliant. Officials from NCUA and the National Association of State Credit Union Supervisors told us that all but two state regulators are following the same Year 2000 examination strategy established by NCUA; the other two state regulators are planning on performing added steps in addition to performing those included in NCUA's strategy.

The second aspect of NCUA's strategy—information dissemination—seeks to heighten credit union awareness of the Year 2000 problem. In August 1996 and June 1997 letters to federally insured credit unions, NCUA formally alerted credit unions to the potential dangers of the Year 2000 problem, identified the specific impacts the problem could have on the industry, provided detailed explanations of the problem, and identified steps needed to correct the problem. It also related its plans to include Year 2000 evaluations in regular examinations and provided credit unions with copies of its examination guidance. In addition, NCUA has appointed a Year 2000 executive responsible for achieving Year 2000 compliance industrywide and assigned Year 2000 compliance officers to its central office and six regional offices. These staff will be responsible for serving as Year 2000 focal points to coordinate efforts across the agency. Finally, NCUA is working with credit union trade groups, such as the Credit Union National Association, in raising awareness of Year 2000 issues.

The third component of NCUA's program—vendor compliance—targets organizations that provide electronic data processing services to credit unions. According to NCUA, approximately 40 vendors provide data processing services to 76 percent of all federally insured credit unions, which account for 79 percent of federally insured credit union assets. Consequently, it is vital that these vendors correct their own systems and help ensure that information can be easily transferred after the Year 2000 deadline. NCUA has begun identifying and contacting major EDP vendors, and it plans to assess their efforts through questionnaires. Specifically, in May 1997 and again in August 1997, NCUA mailed a questionnaire to the 87 vendors, including the 40 vendors that support the bulk of credit unions, requesting information on Year 2000 readiness and, as of September 1997, had received 29 responses.

**Concerns With
NCUA's Year 2000
Efforts**

While NCUA has initiated actions to build the Year 2000 issue into examinations and to raise awareness about the issue among credit unions and their vendors, our work to date has identified four issues that must be

Appendix I
GAO's October 22, 1997 Testimony

addressed to provide greater assurance that NCUA efforts will be successful.

First and foremost of our concerns is that NCUA still does not have a complete picture of where credit unions and their vendors stand in resolving the Year 2000 problem, and current efforts to determine credit union compliance are behind the schedule established by GAO and NCUA. To collect information from the credit unions on their Year 2000 status, NCUA examiners used a high-level questionnaire that inquired whether (1) credit union systems were capable and ready to handle Year 2000 processing, (2) plans were in place to resolve the problem, (3) enough funds were budgeted to correct systems, and (4) responsibility and reporting mechanisms were appropriately established to support the Year 2000 effort. NCUA issued a separate high-level questionnaire to credit union vendors. However, as of the time of our work, NCUA had not yet queried 20 percent of the credit unions and had only received 29 of the 87 vendor responses. In addition, of the credit union and vendor responses received, NCUA has not yet analyzed the information to determine which credit unions and vendors are at high risk of not correcting their systems on time.

This problem is compounded by the fact that the NCUA questionnaires did not inquire about the status of efforts in completing each important phase of correction: (1) raising awareness of the problem, (2) assessing the complexity and impact the problem can have on systems, (3) renovating, or correcting, systems, (4) validating, or testing, corrections, and (5) implementing corrected systems. The questionnaires also did not include system interface issues. For example, they did not inquire about (1) identifying interfaces with outside organizations and their systems, such as payment, check clearing, credit card, and benefit transfer systems, and (2) establishing agreements with these organizations specifying how data will be exchanged in the year 2000 and beyond.

As a result, even when NCUA assesses the results, it still will not have a complete understanding of how far along the industry is in addressing the problem. In addition, NCUA examinations are conducted only on an annual basis. This means that each credit union will be examined only two more times between the end of 1997 and the year 2000. Further, NCUA has not yet established a formal mechanism for credit unions to submit interim progress reports to provide an up-to-date picture of individual correction efforts between examinations. NCUA officials told us that examiners perform off-site supervision in between exams by tracking performance

Appendix I
GAO's October 22, 1997 Testimony

via credit union financial reports and by contacting credit union officials should a problem arise. However, this may not be enough given the seriousness of the problem and the fact that the Year 2000 deadline is just 2 years away.

Further complicating NCUA's situation is the fact that it is still involved in assessment phase activities. According to OMB and GAO guidance, these activities should have been completed back in the summer. As it stands, NCUA does not plan to complete them until the end of this calendar year.

Accordingly, we believe NCUA should accelerate agency efforts to complete the assessment of the state of the industry by no later than November 15, 1997, rather than waiting until the end of the year. NCUA should also collect the necessary information to determine the exact phase of each credit union and vendor in addressing the Year 2000 problem. Because NCUA currently does not have a process in place for interim reporting of this information between examinations, NCUA should require credit unions to report the precise status (phase) of their efforts on at least a quarterly basis. One option would be to use the financial reports, commonly referred to as call reports, that credit unions provide to NCUA quarterly. As part of this report, NCUA should also require credit unions to report on the status of identifying their interfaces to determine whether this issue is being adequately addressed and, if not, require credit unions to implement such agreements as soon as possible.

A second concern we have with NCUA's efforts is that the agency does not yet have a formal contingency plan. Our Year 2000 Assessment Guide³ calls on agencies to initiate realistic contingency plans during the assessment phase for critical systems to ensure the continuity of their core business processes. Contingency planning is important because it identifies alternative activities, which may include manual and contract procedures, to be employed should systems fail to meet the Year 2000 deadline. NCUA guidance directs credit unions to conduct contingency planning, and NCUA officials told us that they have developed numerous contingency options and have discussed among the staff what steps to take should a credit union not be compliant by January 1, 2000. However, officials stated that the precise actions have not been documented in a formal plan. Not having this plan increases the risk of unnecessary problems in an already uncertain situation. Consequently, we recommend that NCUA formally document its contingency plans.

³GAO/AIMD-98-14, September 1997.

A third concern that we have is that credit union auditors may not be addressing the Year 2000 problem as part of their work. NCUA requires each credit union to perform supervisory committee audits. These audits are to determine whether management practices and procedures are sufficient to safeguard members' assets and whether effective internal controls are in place to guard against error, carelessness, and fraud. They are conducted by the credit union's supervisory committee staff or by an outside accountant. However, NCUA officials noted that such reviews typically focus on general controls (e.g., ensuring accurate data is entered into the system, securing data from unauthorized use) and would not specifically include controls to prevent malfunctions due to the Year 2000 problem. Audits are an integral management control and expanding their scope to include important and high-risk Year 2000 issues is critical since it would provide credit union management with greater assurance and understanding about where their institution stands in addressing the problem.

Accordingly, we are recommending to NCUA that it require credit unions to implement the necessary management controls to ensure that these financial institutions have adequately mitigated the risks associated with the Year 2000 problem. Specifically, NCUA should require credit union auditors to include Year 2000 issues within the scope of their management and internal control work and report serious problems and corrective actions to NCUA immediately. To aid credit union auditors in this effort, NCUA should provide the auditors with the procedures developed by NCUA for its examiners to use in assessing Year 2000 compliance and any other guidance that would be instructive.

We also believe NCUA should require credit unions to establish processes whereby credit union management would be responsible for certifying Year 2000 readiness by a deadline well before the millennium. Such a certification process should include credit union compliance testing by an independent third party and should allow sufficient time for NCUA to review the results.

Our fourth concern is that NCUA does not have enough staff qualified to conduct examination work in complex technical areas. At present, NCUA is in the process of hiring one EDP auditor to help examine thousands of credit unions. Recognizing this weakness, NCUA is considering hiring up to three EDP auditors. However, these personnel additions may still not suffice given the tremendous workload and the short time frame for getting it done. To mitigate this concern, we recommend that before the end of the

Appendix I
GAO's October 22, 1997 Testimony

year, NCUA determine the level of technical capability needed to allow for thorough review of credit unions' Year 2000 efforts and hire or contract for this capability.

Summary

Our initial work showed that NCUA has made some progress in addressing Year 2000 compliance issues for credit unions systems that it regulates. However, we are concerned that NCUA (1) is behind schedule and does not yet know the exact status of credit union Year 2000 readiness, (2) has not prepared a formal, detailed plan for contingencies, (3) does not have assurance that sufficient credit union management controls are in place to address Year 2000 problems, and (4) is lacking sufficient technical capability. These concerns lead us to believe that NCUA needs to do more to ensure that credit unions have adequately mitigated the risks associated with the Year 2000 problem, and we have made recommendations to assist NCUA in addressing these issues.

(511105)

Page 9

GAO/T-AIMD-98-20

Comments From the National Credit Union Administration



National Credit Union Administration

October 30, 1997

The Honorable Robert Bennett
Chairman, Subcommittee on Financial Services and Technology
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Bennett:

Thank you for allowing the National Credit Union Administration (NCUA) time to prepare an appropriate response to the issues raised in the General Accounting Office's (GAO's) testimony before your subcommittee on October 22, 1997 regarding NCUA's Year 2000 (Y2K) efforts. As I stated in my letter to you earlier this week, NCUA believes that GAO's testimony contains useful recommendations on quarterly reporting, management certification and notification to credit union auditors. However, NCUA has concerns over the appropriateness of some of the observations and actions requested of the Agency. Additionally, some of the recommendations will require decisions by the NCUA Board on policy and budgetary matters.

Attached is a more in-depth analysis of the issues raised in GAO's report and Agency documents that clarify NCUA's efforts to ensure that all federally insured credit unions are compliant with Y2K requirements. I appreciate the recommendations provided by GAO. Even though NCUA has limited resources, I believe the Agency has developed strategies to appropriately meet the underlying concern leading to each of GAO's recommendations. During the 1998 budget review, the NCUA Board will consider, as appropriate, the devotion of further resources to Y2K efforts.

NCUA developed an approach designed to build a solid foundation in the examiner staff, to assure that the credit union industry is made aware of the seriousness of the issue, and that a plan is in place which will best ensure Agency as well as industry compliance. The safety and soundness examination process is still the most critical of NCUA's initiatives. NCUA has performed its assessment as part of the safety and soundness examination at individual credit unions, where possible, to assure that a dialogue was started regarding the Y2K compliance process.

The NCUA Board will have the initial assessment, using the instrument approved by the Federal Financial Institutions Examination Council (FFIEC), completed by December 31, 1997. This data will identify the credit unions that are not in compliance with Y2K; those that have inadequate plans to achieve compliance; and those that are taking no action at

1775 Duke Street • Alexandria, VA 22314-3428 • 703-518-6300

Appendix II
Comments From the National Credit Union
Administration

all. These results will enable the Agency to develop more specific supervision plans for 1998.

It will not be possible for NCUA to implement a new data collection system to obtain the information recommended by GAO to meet a November 15th deadline due to the large amount of time necessary to develop, implement, and administer such a program. The Agency intends to implement a program of quarterly certifications by credit union officials as to the level of completion they have attained for their critical systems for each phase of the process. NCUA expects to have this data collection system in place for a December 31, 1997 report date with a January 31, 1998, macro overview of the data. This new data collection system will enhance and refine the data gathered during the 1997 assessment efforts.

Because NCUA does not have direct authority over credit union vendors, the Agency will continue to pursue voluntary cooperation with the data collection initiatives from the information system vendors (ISVs).

NCUA will establish written guidelines for use in augmenting the various policies, procedures, and agency instructions on administrative actions. In addition, the Agency will continue its efforts to obtain information from ISVs as to their capacity for conversions from systems that are not able to meet reasonable compliance deadlines.

Agency staff drafted a letter to credit union supervisory committees that will address the need for internal and external auditors to review the Y2K plans and testing processes. NCUA's current regulation requires an assessment of the internal controls in the credit union. Y2K is obviously part of the internal control issues and, therefore, is covered by Agency regulations. Not only will NCUA attach the Y2K examination procedures to that letter for the auditors' information and use, but will also include the Y2K checklists and guidance recently prepared for NCUA by Coopers & Lybrand. This letter is proposed for release in early November.

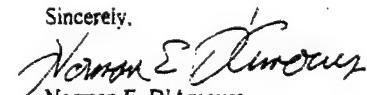
While NCUA cannot hire sufficient additional staff to bring the technical expertise to an appreciably higher level than what currently exists due to the time and resources needed for such recruitment, the Agency contracted with Coopers & Lybrand to review the ten largest ISVs. NCUA is also exploring the possibility of extending contracts for reviews of additional ISVs, credit unions with in-house systems, and select large credit unions. Before committing the resources to this venture, the Agency intends to assess the current contractor's efforts in the initial ten ISV reviews. The 1998 budget proposes a 41 percent increase in the supervision and Y2K resource allocation.

Again, I want to thank you for allowing us an opportunity to provide additional information on NCUA's current activities and plans for future supervision actions. The Agency's supervision of this area will continue to evolve as the examiners and Y2K staff interact with credit unions and determine areas that must be addressed.

Appendix II
Comments From the National Credit Union
Administration

Please feel free to forward any additional questions you have on this matter. NCUA looks forward to the opportunity to discuss the program further.

Sincerely,



Norman E. D'Amours
Chairman

cc: Cindy Sprunger, House Banking Committee
Gary Mountjoy, General Accounting Office

Appendix II
Comments From the National Credit Union
Administration



National Credit Union Administration

NCUA'S RESPONSE
OCTOBER 22, 1997 GAO TESTIMONY

AGENCY PROGRAM

BACKGROUND

NCUA has adopted the Federal Financial Institutions Examination Council plan for managing the industry's efforts to become Y2K compliant. NCUA works closely with the FFIEC working groups on Y2K issues. The assessment questionnaire being used by the Agency is the questionnaire developed by the FFIEC group for use by all financial regulators.

GENERAL SUPERVISION APPROACH

Credit unions come in a wide variety of asset size and operational complexity. Consequently, NCUA's examination and supervision approach must meet many diverse needs in assuring the safety and soundness of the industry. NCUA's program is developed to maintain maximum flexibility which enhances the ability to react not only quickly, but appropriately to the unique factual situations presented by any range of credit union problems. While Agency staff may use the same tools in each examination, they do not use a "cookie cutter" approach to resolving problems. Such an approach, in addition to stifling innovation, would unnecessarily and inappropriately micro manage credit unions. NCUA works to keep the accountability and responsibility for corrective actions needed to obtain the desired results squarely in the hands of the credit union management. NCUA then evaluates the results and the process used to achieve the results.

NCUA has established a basic foundation on Y2K in both the examiner ranks and the credit union community. NCUA established that foundation internally through a hierarchy of Y2K Specialists at the supervisory examiner group, regional, and national levels. The Agency raised awareness within the industry through a series of three Letters to Credit Unions, publication of several articles, many speaking engagements, and the establishment of a Y2K section in the Agency's web site. The Agency Y2K program takes advantage of the training potential in the normal examination/supervision process between the examiner and credit union officials and staff. Additional training has increased technical competence and familiarity among the examiners on this technical issue. Consequently, their effectiveness in dealing with Y2K has been increased by casting the problem in familiar terms of management controls over an EDP conversion process. NCUA also cast the Agency's Y2K enforcement efforts into the normal actions taken when any credit union has an area of concern that must be corrected.

1775 Duke Street • Alexandria, VA 22314-3425 • 703-518-6300

Appendix II
Comments From the National Credit Union
Administration

GAO RECOMMENDATIONS

ASSESSMENT OF Y2K READINESS

GAO's testimony provides some quality recommendations in this area that NCUA will pursue. However, some of the observations need clarification and the deadlines are not attainable.

Credit Union Readiness

As stated earlier, NCUA's questionnaire process is part of an interagency approach to determining the status of financial institutions. The questionnaire is being completed by examiners as they examine the individual credit unions on site or perform off-site supervision contacts.

In its testimony, the GAO is critical of a perceived lack of attention to the interface and payment systems issues. In NCUA's letter to all federally insured credit unions on June 3, 1997, the interface issues are discussed and the risks for credit unions are outlined. Review of NCUA Letters to Credit Unions with credit union management represents a normal part of the supervision process. *In addition, the examination procedures distributed at Y2K training for the Agency's group specialists address this issue specifically.* NCUA believe this information is picked up in the first question in the FFIEC questionnaire as it requests whether the hardware, software, and telecommunication systems used by the credit union are in compliance. All of the interface and payment systems fall into at least one of these categories.

NCUA has also taken a first look at the data, and found a number of false positive responses. Agency staff communicated that fact to the GAO investigators. NCUA is in the process of working with the Agency's regional directors and examiners to correct the data and assure that all the questions are being answered in a consistent and accurate manner. It is important that any misconceptions regarding the content of specific questions are cleared up with Agency staff to avoid reporting inaccurate results to external parties.

The GAO noted that the questionnaire "does not inquire into the status of efforts in completing each phase of correction." Agency staff estimates that developing and implementing a new data collection system would take a minimum of 60 days, well beyond the GAO recommended deadline of November 15, 1997. NCUA will develop a system, implement the system, and have examiners collect valid information on the 11,300 federally insured credit unions to track the ongoing status of Y2K compliance.

By December 31, 1997, through the FFIEC data collection process, NCUA will know those credit unions that are not compliant, those that have a deficient action plan in place, and those that are doing nothing. The Agency's supervision process for 1998 will be

Appendix II
Comments From the National Credit Union
Administration

further refined upon collection of this information, as covered in the FFIEC Y2K Project Management Plan issued in May 1997. NCUA supervision may include on-site contacts, early examinations, and other administrative actions depending upon each credit union's specific factual situation.

The GAO comments regarding quarterly reporting and management certification will be incorporated to evolve NCUA's supervision approach to its next logical level. Unfortunately, the use of a third party certification and testing agent is not feasible considering the resources available to most of the credit unions. In recent testimony, Harris N. Miller, President of the Information Technology Association of America (ITAA), stated that an adequate amount of staff has to be available to complete just the questionnaire portion of the certification process ITAA is using. In addition, Mr. Miller goes on to discuss the fact that ITAA's certification program does not "test software per se in every environment in which they use it," but rather the "focus is on the processes and methods that organizations use to develop Y2K software." ITAA's approach does not differ significantly from the work being done by NCUA examiners, except that in addition to reviewing processes and methods, NCUA looks for results. Credit unions tend to have very lean staff levels. Requiring the type of third party certification discussed in Mr. Miller's testimony may be unnecessarily burdensome to a majority of credit unions.

NCUA is looking to implement a system that will require credit union managers to certify their level of completion on each of the five phases on a quarterly basis. To collect this data and certification requires an OMB number under the Paperwork Reduction Act. Even if NCUA obtains OMB approval for emergency processing, Agency staff believes that it will take almost 30 days to complete. Without approval for emergency processing, this process takes at least 90 to 120 days. NCUA will immediately pursue the emergency processing of an OMB number. If NCUA is not approved for emergency processing, the Agency will begin to use the certification on a volunteer basis until the data collection form is approved. NCUA plans to collect the first information under this program as of December 31, 1997. The data will flow to Agency examiners and regional offices for updating each credit union's individual supervision plan, and then will be captured on a national basis for macro reporting. The first report should be available by January 31, 1998.

The GAO testimony indicates that NCUA is only on-site at a credit union during the annual examination. The Agency's supervision includes both off-site monitoring and on-site contacts. Of the 79,730 hours in supervision used to date in 1997, 43,047 hours were for on-site contacts or 54%. The proposed budget for 1998 includes over 100,000 hours of supervision time above the 550,000 hours of examination time and an additional 42,000 hours for Y2K oversight. The combination of 1998's proposed supervision and Y2K time represents a 41% increase over 1997.

Appendix II
**Comments From the National Credit Union
Administration**

EDP Vendor Readiness

NCUA staff provided the GAO with a legal opinion from the Office of General Counsel that states that the Agency's ability to obtain information from ISVs is limited to voluntary cooperation or subpoena power. While unable to meet GAO's requirement that NCUA determine the compliance status of the ISVs by November 15th, the Agency is exploring avenues regarding the ISV issues which balance the activities with the potential to cause the vendor substantial competitive harm. Any vendor that either lost clients or went out of business would adversely affect their client credit unions and potentially cause unnecessary losses to the NCUSIF.

NCUA's outside contractor is proceeding to conduct Y2K reviews on a voluntary basis at the ten largest ISVs starting December 1997 through February 1998. The initial 10 reviews should cover approximately 6500 credit unions with EDP systems or 58% of the total federally insured credit unions. Additional reviews will be conducted as appropriate. The review report will evaluate the following:

- The state of compliance or non-compliance of the ISV, and the potential impact on credit unions of its specific areas of non-compliance;
- An assessment of the ISV's understanding of the problem and their specific vulnerabilities, and a summary of their plans to resolve the problem;
- An assessment of the viability and timeliness of plans to resolve the problem; and
- An assessment of the extent of the problems found in terms of the number and size of credit unions serviced by the ISV.

Summary

NCUA's approach of building a solid foundation in its examiner staff and assuring that the credit union industry was made aware of the seriousness of the issue was a necessary first step. The safety and soundness examination process is still the most critical of the Agency's several initiatives. NCUA has performed the assessment as part of the safety and soundness examination, where possible, to assure that a dialogue regarding the compliance process was started and resources were minimized by reducing the number of trips to a credit union site. This initial assessment will be completed on all credit unions by December 31, 1997.

CONTINGENCY PLANNING

NCUA routinely works with credit unions that find themselves in problem situations. The Agency has regional director delegated authority, policies and procedures, instructions, manuals, and tracking systems for the assistance and administrative actions. This aspect of credit union supervision is not unusual for the Agency. NCUA will treat Y2K major

Appendix II
Comments From the National Credit Union
Administration

problems with the same swift administrative action that it uses for any crisis faced by a credit union and well in advance of December 1999. NCUA will develop additional written guidance augmenting the current documented processes for administrative action. Agency staff expects this work to be completed by November 30, 1997.

Part of NCUA's contingency planning includes assessing the potential excess capacity in the industry for EDP services. The Agency will be holding a vendor conference in December and at that time will develop information regarding the vendors' ability to absorb new clients. The information will look at total numbers and the speed with which credit unions could be converted to a compliant system. This information will be built into the written plan NCUA develops to augment the current administrative action processes.

Because NCUA has no statutory supervisory authority over the ISVs, all of the agency's activities with the vendors must be on a voluntary basis. Accordingly, NCUA is still pursuing ways that the Agency can legally convey information regarding a vendor's compliance or lack thereof without stepping across the boundary of causing "substantial competitive harm." Through conferences, letters to the vendors, and publication of the contingency plans, the Agency should be able to attain voluntary compliance from a majority of the vendors.

USE OF CREDIT UNION SUPERVISORY COMMITTEE AUDITORS

NCUA has not singled out the activities of the credit union supervisory committee internal and external auditors in the Y2K arena for special review. NCUA's regulation requires the supervisory committee or its designee to assess the control structure at the credit union at least annually. The Agency believes that to meet the regulation, external auditors should at least assess the credit union's progress towards Y2K compliance as it is a major internal control issue.

However, since NCUA has not yet specifically addressed this issue, the Agency now plans to send a letter to the chairman of each credit union's supervisory committee. This will put the supervisory committee on notice that they should use their resources to ensure the operational integrity of the credit union's systems. This NCUA letter will re-emphasize the regulatory requirement. It will also recommend that credit unions with internal auditors use them to review and validate the testing process on an ongoing basis. In addition, the letter will urge supervisory committees to complete the Y2K compliance review early in the audit cycle, rather than later.

The GAO testimony suggests that NCUA forward the examination procedures to the auditors used by credit unions. NCUA forwarded the examination procedures to each federal credit union earlier this year. While, in theory, this should assure that they are available for the auditor, NCUA will also attach the procedures to the letter to the supervisory committee chair.

Appendix II
Comments From the National Credit Union
Administration

NCUA TECHNICAL CAPABILITY

While NCUA does not currently employ any EDP auditors, the Agency is recruiting for one approved position. While the Board will consider increasing the number of EDP auditors to three for the 1998 budget cycle, at present the Agency has neither the resources nor sufficient time to hire and develop a larger staff of EDP Auditors. Therefore, the Agency must look to alternative ways to meet its responsibilities in this area.

NCUA hired Coopers & Lybrand on August 25, 1997. In addition to the EDP reviews cited above, Coopers & Lybrand has conducted training seminars for the examiner staff in the basic issues to review in each credit union. Since examiners cannot perform the application checks, NCUA must instead insist that the credit union have a viable plan to implement and assess those checks. Again, NCUA must recast the problem into one that is workable within the Agency's constraints. NCUA holds each credit union accountable and responsible for conducting the appropriate testing and review of internal controls, rather than having Agency staff perform that testing. The Agency has the expertise to assure that credit unions meet their plans, assess the test results, and take appropriate action to revise the plan as needed based on those results. NCUA has the ability to take administrative action when the process is not working.

NCUA's Information System Specialist positions, even at the proposed level of three, cannot possibly perform all the Y2K work. That effort was never envisioned as part of their function. The positions are being established to provide technical expertise to assist the Agency in developing long-range plans for dealing with a proliferation of information systems issues within credit unions, of which Y2K is one. EDP Auditors will provide leadership on Y2K and other issues within the Agency and to the credit unions.

NCUA has contracted with Coopers & Lybrand to review ten ISVs, on a voluntary basis. Based on the assessment of the quality and benefit of those reviews, the Agency will consider contracting for additional reviews in three areas:

1. Other EDP vendors;
2. In-house system credit unions; and
3. Large credit unions.

The NCUA Board will make the final decision regarding the resources that should be committed to further reviews. The information developed in the first ten reviews by Coopers & Lybrand will provide a basis upon which to make recommendations for additional outside contract reviews. Contracting for expertise is the only viable option to enhance the technical capabilities at this point.

Major Contributors to This Report

**Accounting and
Information
Management Division,
Washington, D.C.**

Gary N. Mountjoy, Assistant Director
John B. Stephenson, Assistant Director
Ronald L. Hess, Senior Information Systems Analyst
Sabine R. Paul, Senior Information Systems Analyst
Keith A. Rhodes, Technical Director
Cristina T. Chaplain, Communications Analyst

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

Orders may also be placed by calling (202) 512-6000 or by using fax number (202) 512-6061, or TDD (202) 512-2537.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

<http://www.gao.gov>

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use \$300

Address Correction Requested

